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In the Supreme Court of the United States

THE BOEING COMPANY AND CONSOLIDATED SUBSIDIARIES,

Petitioners,

v.

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF FOR THE PETITIONERS

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REPLY BRIEF FOR THE PETITIONERS

The government's brief contains a number of remarkable omissions and misstatements. The government never responds *at all* to any of our principal arguments. It virtually ignores the text of the controlling statute. It disregards almost all of the relevant legislative history. It does not even mention crucial regulatory provisions. It misstates the regulatory background. And it makes no attempt to defend the reasoning of the Ninth Circuit.

These omissions and misstatements are central to the government's position. At the end of the day, the government really makes only one argument: that the Court should defer to the government's application of Treas. Reg. § 1.861-8(e)(3) because the DISC statute says nothing about how costs should be assigned to revenues. But this talismanic invocation of deference is manifestly insufficient to carry the day. In fact, the DISC statutory and regulatory regime makes unmistakably clear that product-specific costs must bear a factual relationship to the revenues from which they are deducted; that taxpayers are entitled to choose the method by which they group revenues and expenses; and that such grouping "will be accepted" and "shall be controlling" for purposes of determining CTI. Deference to an agency is inappropriate where, as here, the administrative position is flatly inconsistent with the plain terms of the controlling statute, with other indicia of congressional intent, and with the regulations interpreting that statute. The government's contention therefore should be rejected and the decision of the Ninth Circuit reversed.

A. Costs That Are Directly Related To Particular Income Must Be Allocated Exclusively To That Income

1. In our opening brief, we showed that, when calculating CTI on the basis of product groups that are recognized by industry usage, costs that are directly and factually related to a particular product group must be allocated exclusively to *that* group; they may not be allocated to other product groups to which they are *not* related. The government's response insists that is not so, maintaining that "[t]he applicable statutes do not contair any such [factual relationship] requirement." U.S. Br. 35. This assertion, however, ignores *all* available evidence of Congress's intent.

First, we explained in our opening brief that the factual relationship requirement is established by the DISC statute, which provides that a DISC's CTI is the income "attributable to" an export sale. IRC § 994(a)(2). As this Court has held elsewhere in the federal tax context, "attributable to" means "caused or generated by." *Braunstein* v. *Comm'r*, 374 U.S. 65, 70 (1963). Income "attributable to" a sale therefore necessarily consists of gross revenues from the sale less the factually related expenses that generated the sale. Pet. Br. 18-20. The government nowhere acknowledges the import of this controlling DISC statutory language; *it makes no response at all to our argument on this critical point.*

Second, we explained in our opening brief that Congress intended CTI to "be determined generally in accordance with the principles applicable under [IRC] section 861[.]" H.R. REP. NO. 92-533, at 74 (1971); S. REP. NO. 92-437, at 109 (1971). We noted that Congress enacted the DISC legislation against the background of IRC § 861(b), a statute that had been in effect without substantive change for 50 years and that establishes how deductible costs are assigned to items or classes of gross income when determining the geographical

source of income. In particular, § 861(b) provides that, in calculating net income for this purpose, taxpayers must deduct from a particular item or class of gross income expenses that are "properly apportioned or allocated" to that item or class, as well as a ratable portion of "deductions *which cannot definitely be allocated to some item or class of gross income.*" This formula plainly means that if an expense *can* be allocated to a certain item or class of income, it may *not* be ratably apportioned across all items or classes of income. See Pet. Br. 20-21. We also explained that the regulations interpreting § 861 that the Treasury Department proposed in 1966 – which Congress would have had before it when it enacted the DISC statute five years later – expressly confirmed that deductions definitely related "to a single item or class of gross income *shall be allocated thereto.*" See Pet. Br. 21. Again, the government makes no attempt to address the relevant statutory language, does not acknowledge the proposed regulatory language at all, and *makes no response to our contention on the point.*

Third, we explained in our opening brief that the congressional tax-writing committees declared in unambiguous terms *how* Congress wanted the § 861 allocation and apportionment principles to apply in the computation of DISC income. As both committees put it, CTI is to be calculated by deducting from the DISC's gross receipts those expenses "which are *directly related* to the production or sale of the export property and *a portion* of the * * * expenses not allocable to *any* specific item of income." See Pet. Br. 21-22. Under this formulation, it plainly is improper to require taxpayers to take expenses that *are* directly related to the sale of *particular* property and apportion them to income from the sale of *unrelated* property. Again, although the government cites other portions of the committee reports, it does not quote or acknowledge the crucial report language and *makes no response to our argument on this point.*

Fourth, we explained in our opening brief that the Treasury Department's contemporaneous understanding of the DISC statute, dating back to 1972, recognized expressly that expenses directly related to a particular class of income *must* be allocated to that income in calculating CTI, and that only expenses not definitely related to *any* class of income may be ratably apportioned across income classes. See Pet. Br. 23-24. We also noted that, when the final DISC regulation (with its cross-reference to Treas. Reg. § 1.861-8) was issued in 1975, the proposed § 861 regulation then pending (which was published in 1973) also unambiguously applied the factual relationship principle to R&D in the DISC context. See Pet. Br. 24-26. This contemporaneous agency understanding has particular force in determining the meaning of the controlling DISC statute. See *id.* at 23. Yet again, the government *makes no response to our argument on this point.*

Instead, the government spends considerable space addressing an argument that we do not make. The government maintains that the Secretary is not "bound by each and every phrase in a proposed regulation" and that "the 1973 *proposed* [§ 861] regulations" do not govern here. U.S. Br. 38, 40 (emphasis in original). Our point, however, is not that the 1973 proposed version of Treas. Reg. § 1.861-8 has the force of law; it is, rather, that *the Treasury Department's own best understanding of the DISC statute, at the time closest to enactment of the legislation* (when the Secretary drafted the proposed § 861 regulations and issued the final DISC regulations), was that the law precluded the allocation of expenses to a particular class of income when those expenses were definitely and factually related to a different class of income. *The government does not address this point.*[1]

[1] The government appears to suggest that, when the final DISC regulations were issued in 1975, the Treasury Department anticipated that the proposed § 861 regulations would change. Quoting the preamble to the DISC regulations, the government asserts that "[i]n issuing the DISC regulations in 1975, the agency clearly stated that * * * a cross reference in the DISC regulations to other regulations that were, at the time, only proposed is 'intended to refer to such regulations as will be finally adopted.'" U.S. Br. 40 (quoting T.D. 7364, 1975-2 C.B. 315, 316). This misrepresents the preamble, which refers to proposed regulations under *both* sections 993 and 861 but singles out *only* the cross-reference to proposed regulations "under section 993" as being "intended to refer to such regulations as will be finally adopted." T.D. 7364, at 316 (emphasis added). This statement does not extend to the proposed regulations under § 861.

The government's utter failure to offer any response to our arguments regarding the meaning of the DISC legislation is enough to dispose of this case. For the reasons set out in our opening brief and noted above, there can be no doubt that, in calculating CTI based on recognized product groupings, the DISC statute precludes the assignment of costs that are specifically associated with *one* product grouping to income generated from the sale of products from *another* grouping. Yet it is undisputed that the government's application of Treas. Reg. § 1.861-8(e)(3) in this context would have precisely that effect: the government does not deny that (for example) its approach would *require* that R&D costs for the development of an improved cotton ball be deducted from income generated through the sale of space suits. The DISC statute does not allow such a result.

2. Perhaps because it is unable to account for the terms of and intent behind the DISC statute, the government tries to approach its problem from another direction: it makes the astounding assertion that R&D *inherently* lacks a factual connection to income from the sale of particular products. This is so, the government argues, because R&D expendi-

tures invariably "give rise to income, if ever, in a later year," so that "[w]hen (as in the present case) the taxpayer elects to treat its research expenses as current deductions under [IRC] Section 174, rather than as capital expenditures, the logical or 'factual' link between such costs and the income that they generate is thereby severed [and] a 'direct' or 'definite' relationship between the research expense and the associated future income disappears." U.S. Br. 24-25. This contention is wrong on several levels.[2]

a. To begin with, the government's "severance of a definite relationship" argument – which was not made below – is wholly illogical. The fact that R&D expenses give rise to "future income" can hardly justify treating them differently from all other expenses, because virtually *every* expense gives rise to "future income." Expenses that generate income at the moment they are incurred are rare indeed. If R&D expenses differ at all from other expenses in this respect, it is only because the "future," in the case of income generated by an R&D expense, tends more often to be a later *tax period* than is the case of income generated by many other expenses.[3]

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[2] In deciding how seriously to take the government's argument, we note that the rationale advanced in the government's brief apparently has been devised solely for use in this litigation; it was not the actual premise for the regulation. The real justification for the R&D rule, which is stated in the regulation itself, is *not* that it is difficult to determine the relationship of research to particular income, but rather that research is "inherently speculative," that research findings may "contribute unexpected benefits," and "that the gross income derived from successful research and experimentation must bear the cost of unsuccessful research and experimentation." Treas. Reg. § 1.861-8(e)(3)(i)(A). The government makes no attempt to assert *that* rationale here.

[3] That is not invariably so, however. Many types of currently deductible non-R&D expenses – for example, expenses related to the development and implementation of an advertising campaign – give rise to income in future tax periods. See Treas. Reg. § 1.162-20(a)(2) (allowing the current deduction of expenditures for institutional or "good will" advertising "related to the patronage the taxpayer might reasonably expect in the future").

But the government never explains, and cannot plausibly explain, how the "'factual' link between [R&D] costs and the income they generate is severed" by the tax code's arbitrary division of time into annual tax periods.[4]

Indeed, the government's argument on this point is little more than an attempt to repackage the unpersuasive "disappearing R&D" contention that it advanced below and that we address in our opening brief at 37-39. But however it is formulated, the government's contention is squarely contradicted by its own regulations. Treas. Reg. § 1.861-8(b)(1) unambiguously states that expenses must be allocated to the class of gross income to which the expenses are definitely related "without regard to the taxable year in which such gross income is received or accrued or is expected to be received or accrued." And Treas. Reg. § 1.861-8(d)(1) explicitly recognizes that the separation of a deduction and the income it generates into different tax periods does *not* sever the "definite relationship" of the deduction to the income.

Actually, there is reason to doubt that the government believes its own theory. Elsewhere in its brief, the government acknowledges that, "[i]f petitioner had capitalized its research costs, the annual amortization of such costs would

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[4] In fact, whether taxpayers choose under IRC § 174 to deduct R&D expenses currently or to amortize such expenses, the relevant regulations are based on the assumption that taxpayers can – and often must – factually identify current R&D expenses with specific future products or projects. See Treas. Reg. §§ 1.174-1, 1.174-2, 1.174-3, 1.174-4.

then have had a logical or 'factual' relationship to its future income and could then be said to be 'properly attributable' to that income as it is earned." U.S. Br. 41. See also *id.* at 24, 25 n.16. The government therefore recognizes that there *is* a definite, factual relationship between R&D costs and the income from the sale of the particular products those costs helped develop, albeit income that is realized in future years. Simply because the costs are deducted currently rather than capitalized, they do not magically become related to income from *current sales of unrelated products* – a transformation that is deemed to occur by Treas. Reg. § 1.861-8(e)(3).[5]

b. As this last point suggests, there also is a related internal inconsistency in the government's position. As we have noted, the government insists that there is no "definite relationship" between R&D expenses and *any* current income when the taxpayer deducts those expenses immediately, because the income produced by the R&D will be received in future tax years. But the regulation the government is defending has quite a different premise: Treas. Reg. § 1.861-8(e)(3) says that R&D expenses *are* definitely related to *all of that year's income* in the relevant SIC Code. The government therefore is forced to do a quick sidestep and defend the regulation on the ground that, because "[t]he relationship of a research cost to any discrete product is inherently tenuous and difficult to determine" (U.S. Br. 26), the Secretary is free

[5] Put another way, if a taxpayer's R&D produced income in the *same* tax year as the expenditure, even the government presumably would admit that the factual link would not be "severed." Thus, the "time displacement" rationale should not support reapportionment of *those* R&D expenses. Nonetheless, Treas. Reg. § 1.861-8(e)(3) would mechanically reapportion even those expenses to all current income related to the broad SIC Code. It thus is Treas. Reg. § 1.861-8(e)(3) itself that severs the factual link between expenses and income.

arbitrarily to assign such costs to broad product categories. See *id.* at 26-28.

This smorgasbord of arguments, however, simply makes vivid the weakness of the government's position. The government admits in its brief – indeed, it stresses – that R&D inherently gives rise to future-year income. And it acknowledges that there *is* a definite factual connection between research expenditures and future income when those expenses are capitalized. Yet the regulation defended by the government irrationally deems R&D to give rise exclusively to *current-year income* with which the R&D *has no factual connection whatever*. Thus, in this case, the government would require that R&D expenses relating to the improvement of a part unique to an airplane model not yet in production be assigned to current income from the sale of a different type of airplane – a type of airplane that, since it already has been produced, necessarily could not have benefited from that R&D. There is no plausible rationale for such a result.

c. The government also is incorrect in arguing that the Secretary is entitled to allocate R&D costs however he sees fit because the alternative is "to leave this determination to the vagaries of the management and accounting practices of individual taxpayers." U.S. Br. 28. We do not contend that each taxpayer's accounting system has the force of law; rather, the taxpayer's choices must be given effect where they comply with DISC's requirements. And here, it is undisputed that Boeing's approach does conform to the standards set out in the Secretary's own DISC regulations, which (as we explain in more detail below) allow taxpayers to calculate CTI on the basis of individual transactions, recognized industry or trade usage, *or* SIC Code. See Treas. Reg. § 1.994-1(c)(7). In this case, the Secretary has never challenged Boeing's product line groupings and, indeed, has approved the use of those groupings in allocating revenues and

all costs *other than R&D*. The Secretary's conduct therefore itself refutes the government's position.

3. The government gets no further when it argues, on the basis of the FSC statute's legislative history, that Congress meant to ratify the application of Treas. Reg. § 1.861-8(e)(3) to DISCs and FSCs. See U.S. Br. 32-34. Even the Ninth Circuit was not persuaded by this argument, concluding that the materials cited by the government "provide[] no reliable indication of how this case should be resolved." Pet. App. 13a. See *id.* at 12a-13a & n.10.[6]

The government relies on two separate snippets of legislative history to support its ratification argument. *First*, it points to a congressional staff report stating that, "where the provisions of the [FSC] bill are identical or substantially similar to the DISC provisions under present law, the committee intends that rules comparable to the rules in regulations under those provisions will be applied to the FSC." STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 2D SESS., DEFICIT REDUCTION ACT OF 1984: EXPLANATION OF PROVISIONS APPROVED BY THE COMMITTEE ON MARCH 21, 1984, at 636 (Comm. Print 1984). From this, the government would have the Court infer that Congress meant to ratify the application of Treas. Reg. § 1.861-8(e)(3) to DISCs and FSCs. See U.S. Br. 32.

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[6] Even if the government's reading of the legislative history were correct, "re-enactment cannot save a regulation which 'contradict[s] the requirements' of the statute itself. When a regulation conflicts with the statute, the fact of subsequent re-enactment 'is immaterial, for Congress could not add to or expand [the] statute by impliedly approving the regulation.'" *Leary* v. *United States*, 395 U.S. 6, 25 (1969) (citations omitted). Here, for reasons explained above, Treas. Reg. § 1.861-8(e)(3) cannot be reconciled with the statutory language.

Whatever the value of the staff report as a guide to Congress's intent in the DISC and FSC statutes, the government plainly misreads that document. The staff report says only that Congress intended the same rules to apply under DISC and FSC. And "the regulations under [the DISC] provisions" alluded to in the report provide that the costs "relating to gross receipts" are those costs "definitely related" thereto, as well as a ratable portion of other expenses "which are not definitely related to a class of gross income" (Treas. Reg. § 1.994-1(c)(6)(iii)) – the very rule we are contending for here. That, presumably, is the approach that the staff had in mind when it said that similar rules should be applied under FSC. In contrast, the DISC regulations made no express reference to special rules for R&D. There simply is *no* evidence that Congress had such special R&D rules in mind when its staff generally approved use of the DISC regulations for FSC purposes.

The government tries to finesse this problem by asserting that "[t]he DISC regulations to which Congress referred expressly incorporate the cost allocation rules of 26 C.F.R. 1.861-8(e)(3)." U.S. Br. 32. But that assertion is inaccurate. The DISC regulations in fact state that cost allocations and apportionments are to be performed "in a manner consistent with the rules set forth in § 1.861-8." Treas. Reg. § 1.994-1(c)(6)(iii). They do not "expressly incorporate" the particular rule of Treas. Reg. § 1.861-8(e)(3), which, as we have explained (see Pet. Br. 26 n.14), is a significant deviation from, and is *not* consistent with, either the other rules of Treas. Reg. § 1.861-8 or the general principles of § 861.

Second, the government is equally mistaken when it attempts to find support for its current position in the legislative history of a congressional moratorium that precluded the application of the R&D cost-allocation regulation when determining the geographic *source* of income. See U.S. Br. 32-

33. That moratorium provision, originally enacted in § 223(a) of the Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 249, provided that, for a two-year period, "all research and experimental expenditures (within the meaning of sections 174 of the Internal Revenue Code of 1954) which are paid or incurred in such year for research activities conducted in the United States shall be allocated or apportioned to sources within the United States." This moratorium on the application of the R&D provisions of Treas. Reg. § 1.861-8 for sourcing purposes was modified and extended several times by subsequent legislation.[7] The government now points to the legislative history of the first of these extensions, which stated that the sourcing moratorium "does not apply for other purposes, such as the computation of combined taxable income of a DISC (or FSC) and its related supplier" (H.R. CONF. REP. NO. 98-861, at 1263 (1984)); the government takes this statement to express a congressional view that "the cost-allocation rules of 26 C.F.R. 1.861-8(e)(3) *are* controlling in the calculation of 'combined taxable income' not only for DISCs but also for FSCs." U.S. Br. 33 (emphasis in original).

[7] See Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 126, 98 Stat. 494, 648; Consolidated Omnibus Budget Reconciliation Act of 1985, Pub. L. No. 99-272, § 13211, 100 Stat. 82, 324; Tax Reform Act of 1986, Pub. L. No. 99-514, § 1216, 100 Stat. 2085, 2549; Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 4009, 102 Stat. 3342, 3653-54; Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7111, 103 Stat. 2106, 2326-28; Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, § 11401(a), 104 Stat. 1388, 1388-472; Tax Extension Act of 1991, Pub. L. No. 102-227, § 101, 105 Stat. 1686, 1686; Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13234, 107 Stat. 312, 504.

Again, however, the government reads something into this history that simply is not there. When Congress enacted the moratorium, it was concerned exclusively with the geographical *sourcing* of income, and it therefore limited the moratorium to that context. Congress nowhere indicated that it had examined and approved application of the R&D provision in any other context. Indeed, that it had not done so is made explicit by legislative history that the government fails to cite. In 1986, when Congress extended the moratorium for the third time (see note 7, *supra*), it declared that "[t]he conference agreement does *not* reflect a judgment by the conferees that any provision of the existing regulation is necessarily correct or incorrect." H.R. REP. NO. 99-426, at II-608 (1986) (emphasis added). Accord STAFF OF THE JOINT COMM. ON TAXATION, 99TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 960 (May 4, 1987). This congressional statement flatly contradicts the inference that the government asks the Court to draw from other portions of the legislative history.[8]

B. Taxpayer Choices As To Grouping Govern The Allocation And Apportionment Of Expenses

1. As explained in our opening brief (at 30-35), the DISC and FSC statutes and regulations allow taxpayers to choose

[8] We note that the Eighth Circuit held in 1994 that Treas. Reg. § 1.861-8(e)(3) was invalid as applied to CTI. *St. Jude Med., Inc.* v. *Comm'r*, 34 F.3d 1394, 1402 (8th Cir. 1994). Six years later, Congress enacted the Extraterritorial Income Exclusion Act of 2000 ("ETI"), Pub. L. No. 106-519 § 3, 114 Stat. 2423, which contained provisions that were substantially similar to the CTI provisions of DISC and FSC. See Pet. Br. 3-4. If the Court were to entertain the possibility of legislative reenactment, it therefore could equally be said that Congress most recently reenacted these provisions with the understanding that Treas. Reg. § 1.861-8(e)(3) does *not* apply to the calculation of CTI.

how to group income and associated expenditures, permitting taxpayers to decide whether CTI determinations will be made on the basis of particular sales, on the basis of product groups recognized by industry usage, or on the basis of SIC Code groupings. Application of Treas. Reg. § 1.861-8(e)(3) to the calculation of CTI conflicts with this regime by requiring taxpayers to allocate R&D on the basis of SIC Code groupings in *all* instances. In response to this point, the government makes yet another argument that simply ignores what the DISC provisions actually say: it asserts that there is no conflict because the DISC grouping rules have nothing to do with the calculation of CTI and instead exist only so that taxpayers may "elect *which groups of sales* will be evaluated under one, or another, of the three alternative pricing methods" authorized by the DISC statute (*i.e.*, CTI, 4 percent of gross receipts, or arm's-length transfer price, see Pet. Br. 4 & n.4). U.S. Br. 43 (emphasis in original).

The government's contention that the taxpayer's grouping choice has no bearing on the allocation of expenses is demonstrably wrong. As explained in our opening brief (at 31, 34-35), the DISC regulations provide unequivocally that "the *determinations* under [Treas. Reg. § 1.994-1] are to be made * * * on the basis of" the taxpayer's chosen groupings. Treas. Reg. § 1.994-1(c)(7)(i) (emphasis added). See also Treas. Reg. § 1.925(a)-1T(c)(8) (same under FSC).[9] Those "determinations" include the matching of "gross receipts" with the costs "which relate to such gross receipts" in the calculation of CTI. See Treas. Reg. § 1.994-1(c)(6). There is

[9] The government unaccountably omitted this language from its presentation of the FSC regulations in the appendix to its brief in opposition to the petition for certiorari. Although we pointed out this oversight in our reply at the certiorari stage (at Pet. Br. 4 n.3), the government once again omits this key provision of the FSC regulations in the appendix to its merits brief. U.S. Br. 7a.

no room for doubt on this point: another provision of the DISC regulations – also quoted in our opening brief (at 35) – states that "costs deductible in a taxable year shall be allocated and apportioned to the items or classes of gross income of such taxable year *resulting from [the taxpayer's] grouping*." Treas. Reg. § 1.994-1(c)(6)(iv) (emphasis added).[10] Against this background, the government can deny the existence of a conflict between Treas. Reg. § 1.861-8(e)(3) and the DISC grouping provisions only by baldly misstating the nature of the controlling DISC provisions.

As we also argued in our opening brief (at 31-34), this conflict between the DISC regime and the R&D provision is fatal to the government's position here because the taxpayer flexibility reflected in the grouping rules is central to the congressional purpose underlying DISC and FSC. We explained that this flexibility was critical to the DISC legislation's function as a tax incentive and was sufficiently important that the taxpayer's entitlement to group transactions on the basis of product line or recognized industry usage was made explicit in the text of the FSC statute. IRC § 927(d)(2)(B) (1984). And it is undeniable, as the Eighth Circuit held in *St. Jude Medical* v. *Commissioner*, that application of Treas. Reg. § 1.861-8(e)(3), which overrides the taxpayer's grouping choice, clashes directly with the taxpayer-choice feature of the DISC regime. See 34 F.3d at 1401. The government makes absolutely no response to this point.

2. The government does argue that there can be no conflict between the DISC regime and the R&D provision because the "research expense allocation rules" were adopted

[10] The government quotes from this regulation (at U.S. Br. 42) but, curiously, edits out the language indicating that costs are to be allocated and apportioned according to the taxpayer's grouping decision.

"for the *express* purpose" of governing DISC CTI calculations and "would be made a nullity" if not applied in the DISC and FSC context. U.S. Br. 45 (emphasis in original); see *id.* at 22-23 & n.14, 44. But the R&D provision of Treas. Reg. § 1.861-8(e)(3) certainly was not promulgated specifically for the purpose of governing DISC calculations.[11] The general rules of Treas. Reg. § 1.861-8 apply for a multitude of international tax purposes and provide allocation rules for many types of expenses apart from R&D. See Treas. Reg. § 1.861-8(e), (f)(1). By contrast, the R&D provision was a small piece of the lengthy regulation, and the remainder of that regulation is consistent with (and may be applied to) the computation of DISC income. At the same time, the R&D rule may be applied in numerous contexts not involving the calculation of DISC CTI income. It therefore is ridiculous to suggest, as the government does, that any regulation would somehow be rendered nugatory if the R&D provision were held inapplicable to the computation of CTI.

The government also asserts that the DISC and R&D regulations cannot be thought to conflict because the former contains a cross-reference to the latter. U.S. Br. 44; see *id.* at 22 n.14. This argument, too, is built on moonbeams and wishful thinking. As we have explained, the conflict between the regulations is plain from their express terms. In addition, the cross-reference relied upon by the government was inserted at a time when all of the § 861 regulations *were consistent* with the DISC regime. See Pet. Br. 24-26. Moreover, that cross-reference, as noted above (at 11), refers

[11] The regulatory provision cited by the government for the proposition that use in DISC and FSC CTI calculations was "the *express* purpose for which [the R&D rule] was adopted" (U.S. Br. 45) in fact simply states that CTI calculations are one of the many areas to which the general-purpose § 1.861-8 regulations apply. See Treas. Reg. § 1.861-8(f)(1).

generally to Treas. Reg. § 1.861-8 and *not* to the specific R&D exception of Treas. Reg. § 1.861-8(e)(3), which was added years after the enactment of DISC. The DISC rules that deal with grouping (and specifically provide that costs are to be assigned in conformance with the taxpayer's grouping decisions), meanwhile, do *not* contain a cross-reference to the § 861 regulations. The cross-reference therefore simply cannot bear the weight placed upon it by the government.

Given Treas. Reg. § 1.861-8(e)(3)'s patent inconsistency with the DISC statute and regulations and every other indicium of congressional intent regarding DISC, we suggested in our opening brief (at 29) that it would be best to interpret Treas. Reg. § 1.861-8(e)(3) not to apply to the computation of CTI. The government ridicules this argument as frivolous on the ground that Treas. Reg. § 1.861-8 states that its provisions apply to the computation of CTI. U.S. Br. 22 n.14. But Treas. Reg. § 1.861-8(e)(3) by its *own* terms specifies R&D allocation rules that apply only "ordinarily," which necessarily must mean that those rules do not *always* apply for one or more of the purposes for which Treas. Reg. § 1.861-8 otherwise generally is applicable. The government has no answer to this argument.

In any event, the government's quixotic attempt to reconcile the conflicting regulations misses the real point. As we also suggested in our opening brief (at 29), it does not ultimately matter whether the Secretary intended Treas. Reg. § 1.861-8(e)(3) to govern the calculation of CTI because such an outcome is inconsistent with the plain terms and manifest purpose of the DISC statute and regulations. Again, the government makes no response to that point.

C. The Secretary's Current View Is Not Entitled To Deference

Ultimately, the government's argument reduces to a naked request that the Court defer to the Secretary's application of Treas. Reg. § 1.861-8(e)(3). See U.S. Br. 19-22. But whether or not that regulation is thought to be "legislative" in character, as the government maintains,[12] it is black letter law that deference is inappropriate when the agency's view is inconsistent with the governing statute. See, *e.g.*, *United States* v. *Vogel Fertilizer Co.*, 455 U.S. 16, 26 (1982); *United States* v. *Larionoff*, 431 U.S. 864, 871-873 (1977). And for reasons we have explained, that manifestly is the case here.

Although that should be the end of the matter, we note that the government also is wrong in asserting that our argument "ignores the settled rule that the agency's interpretation of its own regulations is 'entitled to controlling weight unless it is plainly erroneous or inconsistent with the regulation.'" U.S. Br. 45. As discussed above, the government's application of the R&D provision *is* inconsistent with the DISC regulations and is thus *not* entitled to any weight. Furthermore, as we argued in our opening brief, the general R&D provision should yield to the specialized DISC regulations that were specifically designed to govern CTI determinations. See Pet. Br. 29; see also *Busic* v. *United States*, 446 U.S.

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[12] The government quotes (but carefully does not itself endorse) the Ninth Circuit's statement that Treas. Reg. § 1.861-8(e)(3) is "legislative" because it was issued pursuant to the grant of authority provided by IRC § 863(a). U.S. Br. 19. In fact, as the Eighth Circuit observed in *St. Jude Medical*, "Section 1.861-8(e)(3) was *not* promulgated pursuant to a specific grant of authority." 34 F.3d at 1400 n.11 (emphasis added). Instead, the "general R&D allocation rules, applicable to multiple operative sections of the Code, were promulgated pursuant to the Commissioner's *general* grant of authority in I.R.C. § 7805(a)." *Ibid.* (emphasis added).

398, 406 (1980) ("[A] more specific statute will be given precedence over a more general one, regardless of their temporal sequence."). After all, the DISC regulation "was promulgated to interpret the DISC intercompany pricing rules," while Treas. Reg. § 1.861-8 "was promulgated to 'state in general terms how to determine taxable income of a taxpayer from sources within the United States after gross income from sources within the United States has been determined.' Treas. Reg. § 1.861-8(a)(1)." *St. Jude Med.*, 34 F.3d at 1402 It is the former that should control the determination of DISC CTI.

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The most remarkable aspect of the government's brief is that it does not offer *any* affirmative argument for its position; it does not even attempt to find support for its approach in the statutory language or policy, or explain how its application of the R&D provision advances the congressional purpose underlying the DISC statute. Instead, placing all its bets on its appeal to deference, the government seeks to persuade the Court that the language, background, legislative history, and contemporaneous agency construction of the DISC statute provide *no* guidance on how costs are to be allocated to income when CTI is calculated. But the government is able to make that assertion only by *ignoring* the language, background, legislative history, and contemporaneous agency construction of the DISC statute, all of which *do* provide clear guidance on the point – *i.e.*, the taxpayer's choice of grouping is controlling and costs related to one group may *not* be allocated to revenues in another. Because the government cannot blink away these sources of authority, it should not prevail here.

CONCLUSION

For the foregoing reasons and those stated in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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